SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1950

No. 533

SOKOL BROTHERS FURNITURE COMPANY,
Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent

BRIEF FOR PETITIONER IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

Opinion Below

The decision of the Court of Appeals for the Fifth Circuit is reported at 185 F. (2d) 222 (R. 108-114). The opinion of the Tax Court is reported in C. C. H., Dec. 16,878 (M) (R. 87-95).

Grounds on Which Jurisdiction of This Court Is Invoked

1. The judgment of the Court of Appeals was entered on November 22, 1950 (R. 114) and a timely petition for rehearing was denied on December 27, 1950 (R. 121). The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254(1).

2. The Court below has rendered a decision which is admittedly in conflict with the decision of the Court of

Appeals for the Ninth Circuit on the same matter in the case of *Basalt Rock Co., Inc.* v. *Commissioner,* (C. A. 9, 1950) 180 F. (2d) 281, Cert. Den. 339 U. S. 966 (R. 112).

3. The Court below has rendered a decision on an important question of federal law which has not been but should be settled by this Court.

Statement of the Case

The case is stated in the accompanying petition for a writ of certiorari at page 3.

Specification of Error

The Court below erred in holding that the Petitioner, for the taxable years 1944 and 1945, was required to construct a fictitious "surtax net income" (computed without the benefit of Section 26 (e)) on the accrual basis of accounting, and take 80% of the resulting figure as the over-all limitation of income taxes and excess profits taxes under Section 710 (a) (1) (B) of the Internal Revenue Code, instead of being allowed to use its actual surtax net income (computed on the installment basis of accounting) in such calculation as the statute requires (R. 108-114).

ARGUMENT

The Decision of the Court Below Is Admittedly in Direct Conflict with the Opinion of the United States Court of Appeals for the Ninth Circuit in the Case of Basalt Rock Co., Inc., v. Commissioner (C. A. 9, 1950), 180 F. (2d) 281, Cert. Den. 339 U. S. 966.

The pertinent part of Section 710 of the Internal Revenue Code reads as follows:

> "Sec. 710. Imposition of Tax.
> "(a) Imposition.—

"(1) General Rule.—There shall be levied, collected, and paid, for each taxable year, upon the adjusted excess profits net income, as defined in subsection (b), of every corporation (except a corporation exempt under section 727) a tax equal to whichever of the following amounts is the lesser:

"(A) 90 (95) per centum of the adjusted excess profits nets income, or

"(B) an amount which when added to the tax imposed for the taxable year under Chapter 1 (other than section 102) equals 80 per centum of the corporation surtax net income, *computed under section 15* or Supplement G, as the case may be, but without regard to the credit provided in section 26 (e) (relating to income subject to the tax imposed by this subchapter), (and without regard to 80 per centum of the credit provided in section 26 (h) (relating to credit for dividends paid on certain preferred stock))." (Emphasis supplied)

The Court of Appeals for the Ninth Circuit in the *Basalt* case, *supra,* said:

"In computing petitioner's Sec. 710 (a) (1) (B) corporation surtax net income for 1942, it was necessary to compute petitioner's gross income for 1942. Petitioner's gross income for 1942 included income from long-term contracts—contracts the performance of which required more than 12 months. Petitioner was entitled to elect, and did elect, in its excess profits tax return for 1942, for the purposes of that tax, to compute its income from long-term contracts upon the percentage of completion method of accounting provided by 26 U. S. C. A., Int. Rev. Code, Sec. 736 (b). For all other purposes, petitioner's income from long-term contracts was computed upon the completed contract method of accounting, that being the method regularly employed in keeping petitioner's books of account.

"In computing petitioner's Sec. 710 (a) (1) (B) corporation surtax net income for 1942, the Tax Court computed petitioner's income from long-term contracts

upon the percentage of completion method of accounting.

* * * * * * *

"Section 736 (b) did not authorize petitioner to elect, for the purpose of computing its Sec. 710 (a) (1) (B) corporation surtax net income, to compute its income from long-term contracts upon the percentage of completion method of accounting, nor did petitioner make any such election. Petitioner's election under Sec. 736 (b) applied to the computations required by Sec. 710 (a) (1) (A). It did not apply to any of the computations required by Sec. 710 (a) (1) (B).

"Section 35.736 (b)-3 of Treasury Regulations 112, in so far as it provided that Sec. 710 (a) (1) (B) corporation surtax net income should 'be determined by computing the income from long-term contracts upon the percentage of completion method of accounting,' was inconsistent with Sec. 710 (a) (1) (B) and hence was invalid.

* * * * * * *

"It follows that the Tax Court's computation of petitioner's excess profits tax for 1942 was incorrect.

"The decision is reversed, and the case is remanded to the Tax Court for further proceedings in conformity with this opinion."

There is no discernible difference, in principle, between the regulations under Section 736 (a) and Section 736 (b). The pertinent part of Regulations 112, Section 35.736 (a)-3, as amended by T. D. 5388, reads as follows:

"*For the purpose of determining the excess profits tax under Section 710 (a) (1) (B)* as an amount which when added to the normal tax and surtax for such years figures 80% of the corporation surtax net income computed without regard to the credit under Section 26 (e) *the corporation surtax net income shall include income from installment sales computed upon the straight accrual basis.* * * *" (Emphasis supplied)

The pertinent part of Regulations 112, Section 35.736 (b)-3 reads as follows:

> "The excess profits tax may be computed under section 710 (a) (B) as an amount which when added to the normal tax and surtax computed under Chapter 1 equals 80 per cent of the corporation surtax net income computed without regard to the credit under section 26 (e) (relating to income subject to excess profits tax). *For such purpose the corporation surtax net income shall be determined by computing the income from long term contracts upon the percentage of completion method of accounting.* * * *" (Emphasis supplied)

The first quoted regulation is the one involved in this case. The latter quoted regulation is the one condemned by the Ninth Circuit in the *Basalt* case, supra. There, as here, the Commissioner insisted that the taxpayer use a fictitious surtax net income in computing the 80% limitation.

The Court below in this case, in referring to the *Basalt* case, supra, simply said this:

> "We acknowledge that there is some room for valid argument on both sides of the issue. In any event, the decision of another Court of Appeals upon an issue and principle the same is properly entitled to great weight, and itself affords persuasive argument in the determination of the present case. However, after full consideration, we are unable to follow the decision in the *Basalt Rock Company* case, supra" (R. 112)

The Court Below Has Rendered a Decision on an Important Question of Federal Law Which Has Not Been But Should Be Settled by This Court.

A taxpayer would normally assume, in making the election under Section 736 (a), that his income computed on the

accrual basis would be smaller than his income computed on the installment basis, else he would not make the election. If we are to follow the reasoning of the Court below that the words, "surtax net income, computed under Section 15" in Section 710 (a) (1) (B), require the use of the elected accrual method, in some cases it would result in the imposition of no excess profits tax, even though there might be an excess profits net income. An example of this is set forth in the case of *West End Furniture Co.* v. *Commissioner*, 6 T. C. 557. In that case the taxpayer, when it computed its corporation surtax net income in accordance with the regulation involved in this case and took 80 per cent of that figure, arrived at an amount less than the amount of its normal tax and surtax under Chapter I. As a result the 80 per cent limitation was less than the taxpayer's normal taxes.

The Tax Court in that case in certain dicta which were subsequently eliminated at the request of the Commissioner, said:

> "Petitioner, in its amended excess profits tax return, filed on Form 1121, at Item 13, computed the 80 per cent limitation, provided for in section 710 (a) (1) (B) of the Code, on the basis of a surtax net income computed on the accrual basis, instead of the instalment basis upon which its surtax net income was actually computed. The resulting figure was $23,574.28 and, since petitioner's income tax imposed by Chapter 1 of the Code was of itself in excess of that figure, petitioner concluded that it owed only $23,574.28 in income taxes, and no excess profits tax. It should, however, be pointed out that an erroneous figure was used by petitioner in arriving at the amount which purported to be the limit of income and excess profits taxes which could be imposed by reason of section 710 (a) (1) (B). Its surtax net income, computed under section 15, as section 710 (a) (1) (B) provides, was computed on the installment basis, and it is 80 per cent of that figure which is the limit imposed by section 710 (a) (1) (B)."

Any construction of the statute which would result in the 80 per cent limitation being less than the amount of the taxpayer's normal taxes would be clearly erroneous and something which the Congress never could have contemplated, as Section 710 (a) (1) (B) provides that the alternative tax should be an amount which when *added* to the normal tax and surtax equals 80 per cent of the corporation surtax net income. We submit, therefore, that in the ordinary case the affirmance of the decision of the Court below will result in a diminution of revenue to the Government rather than an increase thereof.

Conclusion

In view of the direct conflict between the decision of the Court below and that of the United States Court of Appeals for the Ninth Circuit in the *Basalt Rock Co.* case, supra, and in view of the importance of the question regarding the administration of our Internal Revenue laws we respectfully submit that the petition for a writ of certiorari ought to be granted.

Respectfully submitted,

CRAMPTON HARRIS,
Attorney for Petitioner.

APPENDIX

Statutes and Regulations Involved

Internal Revenue Code

"Sec. 15. Surtax on Corporations.

"(a) Corporation Surtax Net Income.—For the purposes of this chapter, the term 'corporation surtax net income' means the net income minus the credit for income subject to the tax imposed by Subchapter E of Chapter 2 provided in section 26 (e) and minus the credit for dividends received provided in section 26 (b) (computed by limiting such credit to 85 per centum of the net income reduced by the credit for income subject to the tax imposed by Subchapter E of Chapter 2 in lieu of 85 per centum of the adjusted net income so reduced), and minus, in the case of a public utility, the credit for dividends paid on its preferred stock provided in section 26 (h). For the purposes of this subsection dividends received on the preferred stock of a public utility shall be disregarded in computing the credit for dividends received provided in section 26 (b)."

"(b) Imposition of Tax.—There shall be levied, collected and paid for each taxable year upon the corporation surtax net income of every corporation (except a Western Hemisphere trade corporation as defined in section 109, and except a corporation subject to a tax imposed by section 231 (a), Supplement G or Supplement Q) a surtax as follows:

* * * * * * *

"Sec. 26 (e):

"Income subject to Excess-Profits Tax.—In the case of any corporation subject to the tax imposed by Subchapter E of Chapter 2, an amount equal to its adjusted excess-profits net income (as defined in section 710 (b)). In the case of any corporation computing such tax under section 721 (relating to abnormalities in income in the taxable period), section 726 (relating to corporations completing contracts under the Merchant Marine Act of 1936), section

731 (relating to corporations engaged in mining strategic minerals), or section 736 (b) (relating to corporations with income from long-term contracts), the credit shall be the amount of which the tax imposed by such subchapter is 95 per centum. For the purpose of the preceding sentence the term 'tax imposed by Subchapter E of Chapter 2' means the tax computed without regard to the limitation provided in section 710 (a) (1) (B) (the 80 per centum limitation), without regard to the credit provided in section 729 (c) and (d) for foreign taxes paid, and without regard to the adjustments provided in section 734. This subsection shall not apply to any corporation exempt from such tax under section 725 or section 727."

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"Sec. 44. Installment Basis.

"(a) Dealers in personal property.—Under regulations prescribed by the Commissioner with the approval of the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed, bears to the total contract price."

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"Sec. 710. Imposition of Tax.

"(a) Imposition.—

"(1) General Rule.—There shall be levied, collected, and paid, for each taxable year, upon the adjusted excess-profits net income, as defined in subsection (b), of every corporation (except a corporation exempt under section 727) a tax equal to whichever of the following amounts is the lesser:

"(A) 90 (95) per centum of the adjusted excess-profits net income, or

"(B) an amount which when added to the tax imposed for the taxable year under Chapter 1 (other than section

102) equals 80 per centum of the corporation surtax net income, *computed under section 15* or Supplement G, as the case may be, but without regard to the credit provided in section 26 (e) (relating to income subject to the tax imposed by this subchapter), (and without regard to 80 per centum of the credit provided in section 26 (h) (relating to credit for dividends paid on certain preferred stock).)" (Emphasis supplied)

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"Sec. 728. Meanings of Terms Used.

"The terms used in this subchapter shall have the same meaning as when used in Chapter 1."

"Sec. 736. Relief for Installment Basis Taxpayers and Taxpayers With Income From Long-Term Contracts.

"(a) Election to Accrue Income.—In the case of any taxpayer computing income from installment sales under the method provided by section 44 (a), if such taxpayer establishes, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, that the average volume of credit extended to purchasers on the installment plan in the four taxable years preceding the first taxable year beginning after December 31, 1941, was more than 125 per centum of the volume of such credit extended to such purchasers in the taxable year, or the average outstanding installment accounts receivable at the end of each of the four taxable years preceding the first taxable year beginning after December 31, 1941, was more than 125 per centum of the amount of such accounts receivable at the end of the taxable year, or if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence, in either case including only such years for which the income was computed under the method provided in section 44 (a), it may elect, in its return for the taxable year, for the purposes of the tax imposed by this subchapter, to compute, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, its income from installment sales on the basis of the taxable period for which

such income is accrued, in lieu of the basis provided by section 44 (a). Except as hereinafter provided, such election shall be irrevocable when once made and shall apply also to all subsequent taxable years, and the income from installment sales for each taxable year before the first year with respect to which the election is made but beginning after December 31, 1939, shall be adjusted for the purposes of this subchapter to conform to such election. In making such adjustments, no amount shall be included in computing excess profits net income for any excess profits tax taxable year on account of installment sales made in taxable years beginning before January 1, 1940. If the taxpayer establishes, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, that in a taxable year subsequent to the year with respect to which an election has been made under the preceding provisions of this subsection it would not be eligible to elect such accrual method, the taxpayer may in accordance with such regulations elect in its return for such year to abandon such accrual method. Such election shall be irrevocable when once made and shall preclude any further elections under this subsection. For the taxable year for which the latter election is made and subsequent taxable years, income shall be computed in accordance with section 44 (c).

"(b) Election on Long-Term Contracts.—In the case of any taxpayer computing income from contracts the performance of which requires more than 12 months, if it is abnormal for the taxpayer to derive income of such class, or, if the taxpayer normally derives income of such class but the amount of such income of such class includible in the gross income of the taxable year is in excess of 125 per centum of the average amount of the gross income of the same class for the four previous taxable years, or, if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence, it may elect, in its return for such taxable year for the purposes of this subchapter, or in the case of a taxable year the return for which was filed prior to the date of the enactment of the Revenue Act of 1942, within 6

months after the date of the enactment of such Act, to compute, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, such income upon the percentage of completion method of accounting. Such election shall be made in accordance with such regulations and shall be irrevocable when once made and shall apply to all other contracts, past, present, or future, the performance of which required or requires more than 12 months. The net income of the taxpayer for each year prior to that with respect to which the election is made shall be adjusted for the purposes of this subchapter, including the computation of excess profits net income in each taxable year of the base period under section 711 (b), to conform to such election but for purposes of chapter 1, the tax imposed by this subchapter for any prior taxable year on account of the adjustment required by this subsection shall be considered a part of the tax imposed by this subchapter for the taxable year in which such income is, without regard to this subsection, includible in gross income. Income described in this subsection shall not be considered abnormal income under section 721.

Regulations 112

"Sec. 35.736 (a)-3 (as amended by T. D. 5388). Computation of Income on Straight Accrual Basis.

* * * * * * *

"*For the purposes of determining the excess profits tax under section 710 (a) (1) (B),* as an amount which when added to the normal tax and surtax for such year equals 80 per cent of the corporation surtax net income computed without regard to the credit under section 26 (e) *the corporation surtax net income shall include income from installment sales computed upon the straight accrual basis* described in this section, the credit for dividends received used in computing corporation surtax net income shall be limited to 85 per cent of the net income which shall include income from installment sales computed upon such straight accrual basis, and the normal tax and surtax shall be the

actual normal tax and surtax determined under Chapter 1. (Emphasis supplied).

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"Sec. 35.736 (b)-3. Computation of Net Income Upon Percentage of Completion Method of Accounting.—

"(a) Excess profits tax taxable year.

* * * * * * *

"The excess profits tax may be computed under section 710 (a) (1) (B) as an amount which when added to the normal tax and surtax computed under Chapter 1 equals 80 per cent of the corporation surtax net income computed without regard to the credit under section 26 (e) (relating to income subject to excess profits tax). *For such purpose, the corporation surtax net income shall be determined by computing the income from long-term contracts upon the percentage of completion method of accounting.* The credit for dividends received used in computing corporation surtax net income shall be limited to 85 per cent of the net income determined by computing income from long-term contracts upon the percentage of completion method of accounting, and the normal tax and surtax shall be the actual normal tax and surtax determined under Chapter 1. (Emphasis supplied)

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